



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

January 2, 2001

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
United States House of Representatives
Room 2322, Rayburn House Office Building
Washington, DC 20215-6115

Dear Congressman Dingell:

In June 2000, you and Congressman Markey requested that we provide you with information at the end of the year regarding steps that have been taken in response to the United States General Accounting Office report entitled Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards (GAO/GGD-00-115, June 15, 2000). The attached memorandum responds to that request.

As I told you last summer, I share your concerns regarding unpaid arbitration awards, and I appreciate your continued support for our work in this area. I assure you that the Commission and its staff are committed to the integrity of the arbitration process as an integral component of investor protection and confidence in our markets.

Sincerely,

A handwritten signature in dark ink, appearing to read "Arthur Levitt", written in a cursive style.

Arthur Levitt

Enclosure

Similar letter sent to the Honorable Edward J. Markey

MEMORANDUM

TO: Chairman Levitt

FROM: Annette L. Nazareth, Director *in Nazareth*
Division of Market Regulation

SUBJECT: Action Taken in Response to the U.S. General Accounting Office's Report Entitled Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards

DATE: January 2, 2001

Introduction

On June 27, 2000, Representative John D. Dingell, Ranking Member of the House Committee on Commerce, and Representative Edward J. Markey, Ranking Member of the Subcommittee on Telecommunications, Trade, and Consumer Protection, wrote to Chairman Levitt regarding the findings of the U.S. General Accounting Office ("GAO")'s report entitled Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards (GAO/GGD-00-115, June 15, 2000). This report had been prepared by GAO at the request of Congressmen Dingell and Markey.

The GAO's report indicated that while broker-dealers who remain in the securities business pay the awards entered against them in securities arbitration, a small number of broker-dealers who have left the securities industry never paid the awards entered against them. In response to its findings, the GAO recommended that the Commission take four steps to address this situation: 1) require the National Association of Securities Dealers ("NASD")¹ to adopt procedures for monitoring the payment of arbitration awards; 2) require the NASD to develop procedures to address the problem of unpaid awards caused by failed broker-dealers; 3) work with the self-regulatory organizations ("SROs") to develop investor information on the possibility of unpaid arbitration awards and to encourage investors to investigate thoroughly the backgrounds of the broker-dealers with which they do business; and 4) examine periodically the extent of nonpayment of SRO arbitration awards to determine the effectiveness of actions taken to improve the payment of awards.

In their June 27th letter, Congressmen Dingell and Markey requested information in six months regarding the steps the Commission and the NASD have taken in response to the GAO's recommendations. They also asked for information regarding the results of an inquiry as to whether firms or individuals who had not paid awards were still in business. In addition, Congressmen Dingell and Markey asked the Commission to maintain, for further consideration, information regarding a pilot program that provides

¹ References to the NASD in this staff report typically refer to the NASD's subsidiary, NASD Dispute Resolution, Inc.

investors with access to arbitration fora other than the SROs. This memorandum responds to these requests.

Responses to GAO's Specific Recommendations

In response to GAO's report, the Commission and SROs have taken a number of steps aimed at fostering investor protection. As detailed below, the Commission changed its investor education materials and inspection protocol to address unpaid awards, and has worked with the SROs to implement other changes recommended in GAO's report. In addition, the staff worked with the NASD as it identified whether any current member or registered person has not paid an award.

Specific actions taken in response to the four recommendations that GAO directed to the Commission are discussed below.

(1) Recommendation: GAO recommended that the Commission "require [the] NASD to adopt procedures for monitoring the payment of arbitration awards. Such procedures should include requesting the parties in an arbitration to notify [the] NASD by the end of the 30-day payment period, about the payment status of any monetary award, so [the] NASD can begin timely suspension proceedings against nonpaying broker-dealers, as appropriate."

Actions Taken: As recommended by GAO, the NASD now requires its member firms and associated persons to notify it as each award is paid. In addition, the NASD also now asks investors to notify it promptly if their claims have not been paid. The letter that the NASD uses to serve awards at the end of a case includes this information on notification of award payments. These procedures became effective on September 18, 2000.

The NASD alerted member firm personnel to the new obligation to advise it when awards are paid (or challenged in court) by publishing a Notice to Members ("NTM") on its website on August 10, 2000 (NASD Notice to Members 00-55, Aug. 10, 2000). The NTM also reminds members that awards must be paid within 30 days of service unless a motion to vacate has been filed, and that suspension procedures will be instituted against members that fail to perform these obligations.

(2) Recommendation: GAO recommended that the Commission "require [the] NASD to develop procedures addressing the problem of unpaid awards caused by failed broker-dealers to help reduce costs and increase options for investors, such as the changes [the] NASD is considering."

Actions Taken: A number of steps have been taken to address this recommendation. The NASD advised the staff that it is working on a procedural change, as well as two rulemaking projects, that are designed to provide investors with options and reduce costs when they are pursuing claims against brokers who have gone out of business.

First, the NASD staff is redesigning its procedures to notify claimants systematically if a firm or representative is no longer registered. The NASD has told the staff that it expects to have the new procedures in operation in the first quarter of 2001.

Second, the NASD staff is developing two rulemaking projects intended to help investors who are pursuing claims against certain parties from which it may be difficult to collect award payments. The first would propose a rule to preclude a firm that has been terminated, barred, or suspended, or that is otherwise defunct, from enforcing a pre-dispute arbitration clause against a customer, allowing the customer, instead, to consider legal recourse through the courts. The NASD is considering whether this flexibility might enable some investors to take advantage of expedited procedures in some state courts which, in narrow circumstances, permit the attachment of assets that might otherwise be dissipated if the investor had used the arbitration process. In the second rulemaking project, the NASD is developing a rule that would provide streamlined default proceedings whenever a terminated or defunct member firm or individual registered representative fails to answer or appear in a case, but the claimant elects to continue the arbitration. The staff understands that these rule proposals are progressing through the NASD's review processes. If the NASD determines after its review to go forward with the rules, it would file them with the Commission, which would publish them for public comment.

(3) Recommendation: The GAO recommended that the Commission "work with the SROs to (1) develop and publicize information to focus investor attention on the possibility of unpaid arbitration awards and (2) encourage investors to more thoroughly evaluate the backgrounds of broker-dealers and individual brokers with whom they intend to do business."

Actions Taken: While the Commission has been working with the SROs, it has also taken direct steps in this area. The Commission revised its online publications to advise investors about the potential for unpaid arbitration awards and to underscore the importance of thoroughly investigating a broker's disciplinary history. Language has been added to the on-line versions of three publications: "Invest Wisely," "Ask Questions," and "Check Out Brokers and Advisers."² In addition, the "search key topic" for arbitration on the Commission's website has been amended to add the following language:

Caution: When deciding whether to arbitrate, bear in mind that if your broker or brokerage firm goes out of business or declares bankruptcy, you might not be able to recover your money - even if the arbitrator . . . rules in your favor. That's one of the reasons why it is so important to investigate the disciplinary history of your broker and brokerage firm before you invest. For tips on how to do this, please read our publication entitled Check Out Your Broker.

² New printings of the paper versions of these publications will also include the revised language.

The Commission also revised the standard letter it sends to investors who contact it about problems with broker-dealers. The revised letter explains arbitration and mediation options for pursuing claims against brokerage firms, and cautions investors to “weigh the cost of arbitrating against the likelihood of being able to collect any award in your favor, especially if the brokerage firm has left the industry or gone bankrupt.”

With respect to working with the SROs, the staff worked with the NASD and the NYSE to coordinate changes to their websites. The NASD has added information about the importance of learning about a broker’s background, and the risk of non-payment in several places on its website, including several links to the SEC’s website. For example, the “How to Start an Arbitration” section of the NASD’s website (www.nasdaq.com) includes the following:

Caution. When deciding whether to arbitrate, bear in mind that if your broker or brokerage firm goes out of business or declares bankruptcy, you might not be able to recover your money—even if the arbitrator or a court rules in your favor. That’s one of the reasons why it is so important to investigate the disciplinary history of your broker or brokerage firm *before* you invest. For tips on how to do this, please read the SEC publication entitled *Check Out Your Broker* located on the SEC Investor Education Web Page. Through NASD Regulation’s Public Disclosure Program, investors, and others, can find out background information about brokers and brokerage firms; this information is located on the NASD Regulation Web Site. You should also review the General Accounting Office report *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* GAO/IGD-00-115.

The NASD’s website also now includes a section entitled “What If I Don’t Get Paid?” Information in this part of the website addresses when an award should be paid, interest on awards, disciplinary action for failures to pay awards, the NASD public disclosure program, related court actions to confirm or vacate an award, and links to all of the state arbitration statutes, to the SEC’s website, and to the GAO’s report.

The NYSE has also taken steps in this area. It prepared revisions to its *Guide to Arbitration at the NYSE*, available on its website, to address steps that should be taken by an investor if an award is not paid within 30 days. The staff has been advised that the amended guide will be posted on the NYSE’s website as soon as final Commission action occurs on an unrelated rule change that is also referenced in the guide. The comment period for that proposal closed on December 8, 2000.

The Securities Industry Conference on Arbitration (SICA) has also taken steps to educate investors regarding the possibility of unpaid arbitration awards. SICA drafted amendments to its *Arbitration Procedures* pamphlet, which is used by all of the SROs, to advise investors regarding the steps they should take if they are not paid. SICA is scheduled to act on the revised draft (which also amends other aspects of the pamphlet) at its January 2001 meeting.

(4) Recommendation: GAO recommended that the Commission “periodically examine the extent of nonpayment of SRO arbitration awards to determine the effectiveness of actions taken to improve the payment of awards. To the extent unpaid awards remain a problem, the Commission should establish a process to assess the feasibility of alternative approaches to addressing the problem of unpaid awards.”

Actions Taken: The Office of Compliance Inspections and Examinations (OCIE) has arranged with the NASD to obtain detailed quarterly statistics concerning unpaid awards and related NASD action. OCIE will inspect periodically the NASD’s implementation of its procedures for identifying unpaid awards, and suspending firms or individuals that have not paid the awards. If unpaid awards remain a problem after the new procedures have been assessed, the staff will consider the feasibility of other approaches.

Other Action to Respond to GAO’s Report

Review to determine whether individuals or firms that failed to pay awards remain in the business. The report suggested that some broker-dealers and registered representatives who did not pay awards could still be in the securities business. As a follow-up, the NASD advised the staff that it reviewed records of 140 firms or individual registered representatives for whom the GAO’s survey data suggested there might be unpaid awards.

Registered Representatives. The GAO’s data on unpaid awards included eleven individuals. Six of the eleven were no longer registered with the NASD, while five remain registered. Of the five registered individuals, three were named in cases in which the arbitrators dismissed all claims against them; accordingly, there was nothing for them to pay. The NASD advised the staff that it received proof of payment from one of the two active individuals against whom an award was entered. The other individual has not paid the award entered against him. The NASD advised the staff that it has instituted summary suspension proceedings against that individual, and that he has requested a hearing regarding his ability to pay.

Firms. The GAO’s data on unpaid awards included 21 active NASD member firms. The following summarizes the details of the matters involving the awards against them:

- Fifteen awards were paid in full.
- Two awards were satisfied through a settlement between the parties.
- In one case, the arbitrators dismissed all claims against the firm; accordingly, there was no award to pay.
- In one case, the award was unpaid. That firm’s registration was cancelled in 1999 for reasons unrelated to the unpaid award.

- In one case, the firm entered a stipulated award with the claimant, but did not submit proof of payment. That firm's membership was terminated in June 2000 for failure to pay another award.
- In one case, the firm did not pay the award, and the NASD has begun summary suspension proceedings against the firm.³

Non-SRO Pilot. The Commission is also continuing to monitor the pilot program initiated by SICA that allows investors some access to non-SRO forums for disputes with seven retail brokerage firms. To date, investors have shown little interest in using the pilot. One possible explanation for this hesitance is that the non-SRO forums are more expensive than the SROs, and investors have not been willing to pay those additional costs. Moreover, the staff has also heard from investors' counsel that they have grown accustomed to working with the SRO fora. SICA and individual SROs have encouraged parties who have considered but rejected the pilot to provide their reasons. A law school professor has been tasked by SICA with receiving such comments about the pilot, as well as any evaluations about cases that may be heard under the pilot. The staff will continue to monitor the pilot.

Conclusion

Steps that respond to all of GAO's recommendations have been implemented or, for those that require rulemaking, begun. We intend to monitor the success of these steps with the SROs.

³ The NASD also advised the staff that in the course of its review of the GAO cases, it uncovered the name of an individual who is currently employed by an NASD member not named in the GAO data who had not paid an award. The NASD has commenced summary suspension proceedings against that individual. The NASD also advised that it uncovered the names of two additional individuals not named in the GAO data but responsible for one of the GAO-identified awards. These individuals are not currently employed by an NASD member. Their CRD records have been marked to prevent their future association with a member if the awards remain unpaid.